



Tennessee Valley Authority, 400 West Summit Hill Drive, Knoxville, Tennessee 37902-1499

To TVA Customers:

We are writing today to more fully explain why TVA management believes it is necessary for TVA to raise wholesale power rates effective October 1, 2003. As you know, we have also begun the process to restructure rates and will continue to have discussions with you over the next several months. This letter, however, will focus only on the basis for the potential rate increase.

As we have said, the rate increase is needed to both cover most of the known costs of TVA's clean air program and to enable TVA to continue its trend of debt reduction. Ignoring the effects of price elasticity of demand, a 5.9 percent increase in total wholesale revenues would generate about \$365 million in additional annual revenue for TVA beginning October 1, 2003.

The current regulatory requirements and their costs have been evolving over the past five years, and indeed, continue to evolve. Without a rate increase, TVA would likely return to a period of cash shortfalls that would have to be covered by new TVA borrowings or other financing arrangements. TVA has already absorbed significant environmental costs without a rate increase through spending reductions in other areas, but we can no longer do this.

The TVA Board remains committed to the goal of further debt reduction. We believe that maintaining a positive annual cash flow is essential for long-term financial stability.

Why Now?

TVA is committed to having competitive rates. But in order to meet our environmental requirements, meet the power supply needs of the Valley, and maintain the financial stability of the business, we believe that TVA must increase its rates beginning in fiscal year 2004. Further delay in recovering clean air costs from customers will only compound the problem of cash shortfalls.

More than a year ago, because of the dramatic increase in clean air compliance costs in 2002 and beyond, TVA management approached TVA Board members about the possibility of a rate increase in October 2002. We were charged with reviewing all the numbers one more time and making sure that our clean air strategy was the best available alternative.

While we remain convinced of the need for this rate action in fiscal year 2004, managing our costs effectively will continue to be an integral part of ensuring TVA's financial stability going forward. This year we are doubling our efforts to scrutinize any planned expenditures that can be canceled or deferred, seeking to consolidate TVA office facilities

wherever possible, and working with contractors and labor partners to operate even more efficiently.

TVA's Clean Air Compliance Strategy

The current Clean Air Act includes many sections that require emission reductions at coal-fired power plants. Among these sections are Title IV (Acid Rain Program), National Ambient Air Quality Standards (NAAQS), Regional Haze, and Air Toxics. New Source Review may also require additional reductions.

Emission reductions at coal-fired power plants require the planning, engineering, design, procurement, construction, and testing of expensive systems. The process that leads to the successful operation of these systems can take three to five years. Therefore TVA tries to plan years ahead to make reductions.

Balancing options and resources

TVA management, in consultation with experts throughout the utility industry, keeps abreast of the evolving requirements of the Clean Air Act and develops and revises strategies for future compliance. This is an ongoing process. Compliance with

some portions of the Clean Air Act can be achieved by changing to cleaner fuels, while other portions depend on unit-by-unit command and control and require the installation of emission controls. These differences must be taken into account in planning but can also be used to optimize environmental compliance strategies.

In addition, TVA must schedule the construction and installation of pollution control equipment around the availability of skilled craft labor, access to very large pieces of construction equipment, and the timing of generating unit outages. There has been and continues to be a shortage of skilled craftsmen, especially boilermakers. The impact of this shortage is made more critical by the fact that the utilities around TVA are constructing and installing similar pollution control equipment for the same reasons and often during the same outage seasons. Therefore, there is a limit to how much TVA can do to get the required pollution control equipment operational in a given time period.

Benefits of TVA's strategy

Because of these limitations, and because the portions of the Clean Air Act that provide for the use of emission credits and allowances permit the accumulation, or "banking," of early emission reductions, TVA has chosen in the past to construct and operate some pollution control equipment early. This allowed TVA to bank those early reductions and use them for compliance later. Thus TVA has spread out the construction of the remaining pollution control equipment over a more reasonable period of time. TVA's strategy has saved money in the long run and enabled it to negotiate more favorable contractual arrangements with system designers, vendors, and constructors.

As an example, under Title IV (also known as the Acid Rain Program) of the Clean Air Act, TVA's sulfur dioxide (SO₂) emissions were capped at 430,000 tons beginning in 2000. However, TVA took early action to construct flue gas desulfurization systems (scrubbers) at Cumberland Fossil Plant in the early 1990s, ahead of the compliance date. Consequently, TVA was allowed to bank these early reductions as credits (and in fact was given bonus credits for installing scrubbers) and thus has been able to spread out the construction and installation of additional scrubbers and delay switches to lower-sulfur (more expensive) coal.

In 2002, TVA's SO₂ emissions totaled 547,000 tons, 117,000 tons above our current cap. But because

of the bank of credits TVA built in the 1990s, TVA is fully in compliance.

Similarly, the program requiring the nitrogen oxide (NO_x) emission reductions that TVA is currently making (the EPA NO_x 110 State Implementation Plan, or SIP, rule) also allows the banking of credits from early reductions. So in 2000, 2001, and 2002, when TVA installed the selective catalytic reduction systems (SCRs) at Paradise and Allen Fossil Plants, we developed a bank of NO_x credits. Consequently, even though TVA's ozone season NO_x emission cap will be 39,600 tons beginning in May 2004, the last SCRs that are needed for ultimate compliance will not have to be operational until 2005. Using the banking of credits in this manner has allowed TVA to lower the cost of its compliance program.

Impacts within the Valley

TVA's clean air strategy is based on the policy of being self-compliant by making emission reductions at our own plants rather than depending on purchases of emission allowances from the market. This is TVA's policy for two reasons. First, it eliminates the risk that allowances might not be available in adequate quantities or at a reasonable price when we need them. Second, in keeping with TVA's regional focus, it ensures that expenditures for compliance with the Clean Air Act result in air quality improvements in the Tennessee Valley rather than in some other region of the country.

TVA's strategy also provides a positive economic impact within the Tennessee Valley. Installation of TVA's planned scrubbers will provide Kentucky coal mines with an opportunity to supply up to 7.7 million tons per year of medium- to high-sulfur coal. Construction of the Paradise Unit 3 scrubber will provide roughly 250 to 350 construction jobs during the 24- to 28-month construction period, which represents direct and indirect benefits to the region over the construction period of \$38 to \$50 million. And operation and maintenance of the Paradise Unit 3 scrubber will provide roughly 30 full-time positions, with an economic benefit of about \$3 million annually.

Investments vs. replacements

As TVA implements its clean air strategy, we must be careful not to make investments in generating units that will render them uncompetitive in a wholesale electricity market. Accordingly, TVA has conducted a number of studies evaluating the relative advantages of alternative base-load and intermediate-load power supply options.

Using state-of-the-art models, the operations of coal-fired plants are compared with wholesale power purchases from the market. The cost of this purchased power is assumed to be determined by natural gas combined-cycle units. Based on our current forecasts of natural gas prices, equipment costs, maintenance costs, and coal plant efficiencies; the coal-fired units on which we are installing costly environmental controls are still a better investment than replacing the plants with purchased power from natural gas combined-cycle units.

Investments in emission control equipment allow TVA to continue to take advantage of these very low production cost assets.

Clean Air Compliance Costs and Results

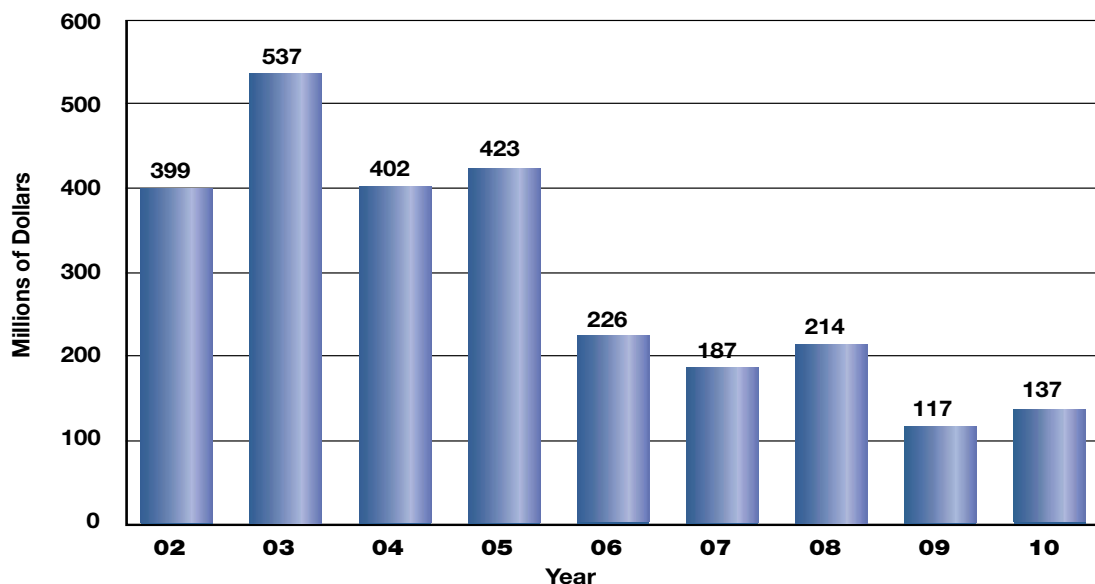
From 1977 through 2001, TVA spent approximately \$3 billion on equipment to control emissions of particulates, SO₂ and NO_x. From 2002 through 2010, TVA estimates it will spend another \$2.6 billion to further control emissions of SO₂ and NO_x. These investments in our coal-fired power plants will reduce emissions as required by sections of the current Clean Air Act mentioned previously. Figure 1 illustrates the future costs anticipated.

TVA's NO_x reduction program

- TVA has installed NO_x reduction equipment and combustion controls on all of its coal-fired boilers. This equipment has already reduced year-round NO_x emissions by 260,000 tons, or 50 percent.

- Currently TVA is spending an additional \$1.1 billion on SCRs to further reduce NO_x emissions.
- The SCR removes NO_x by directing the flue gas into the SCR reactor. Ammonia is injected into the gas, and as the gas passes through a catalyst in the reactor, the NO_x becomes harmless nitrogen and water vapor.
- TVA installed its first SCR at Paradise Fossil Plant Unit 2 in May 2000, and the second system in May 2001 at Paradise Unit 1.
- TVA completed the installation of SCRs at Allen Fossil Plant Units 2 and 3 in the fall and early winter of 2001. All four of these SCRs operated during the 2002 ozone season (May – September), reducing NO_x emissions by over 5,700 tons.
- During the 2003 ozone season, eight SCRs should be operating and will reduce NO_x emissions by about 19,000 tons.
- When completed, TVA's NO_x reduction program will include SCR systems, or equivalent technology, at Allen, Bull Run, Kingston, and Cumberland Fossil Plants in Tennessee; at Widows Creek and Colbert Fossil Plants in Alabama; and at Paradise Fossil Plant in Kentucky. These systems will further reduce NO_x emissions from a total of 25 units.

Figure 1
Committed Clean Air Capital Expenditures



- TVA's NO_x reduction program will have reduced emissions of NO_x during the ozone season by 75 percent since 1995. In 2005, our emissions will be in line with the allocations provided under existing environmental regulations (see Figure 2).

TVA's SO₂ reduction program

- In TVA's continuing efforts to improve air quality and to comply with the Clean Air Act, TVA will design, build, and operate five additional scrubbers to further reduce SO₂ emissions from its coal-fired power plants.
- TVA will install this equipment on the single unit at Bull Run Fossil Plant in Tennessee, on Unit 3 at Paradise Fossil Plant in Kentucky, and on Unit 5 at Colbert Fossil Plant in Alabama. TVA also will install two scrubbers at Kingston Fossil Plant in Tennessee, which will control emissions from all nine units there.
- These five scrubbers will cost approximately \$1.5 billion and will collectively reduce emissions of SO₂ by more than 200,000 tons per year, bringing our emissions in line with the amount of allocations provided in EPA's Acid Rain Program. This will result in an overall decrease of 85 percent since 1977 (see Figure 3).
- Design of the scrubbers will start in 2003; however, peak construction activities must be delayed until completion of TVA's SCR installation program due to craft worker and other resource limitations.
- TVA already operates six scrubbers at its largest units. Two are operating at Cumberland Fossil Plant in Tennessee, two at Paradise Fossil Plant in Kentucky, and two at Widows Creek Fossil Plant in Alabama.

TVA management and utility industry experts expect additional reductions to be required by the Clean Air Act early in the next decade. There is also a growing momentum at the national level to pass new legislation that would require significant emission reductions beyond those currently planned. The cost of those additional reductions could be \$4 to \$5 billion.

Figure 2
TVA Emissions of NO_x

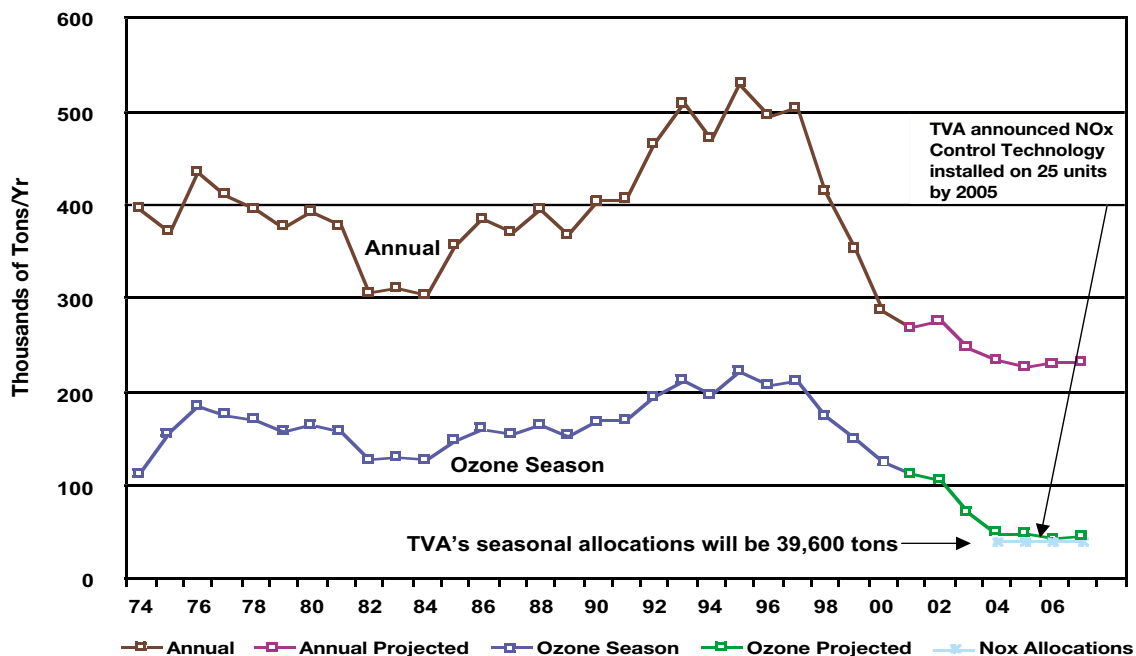
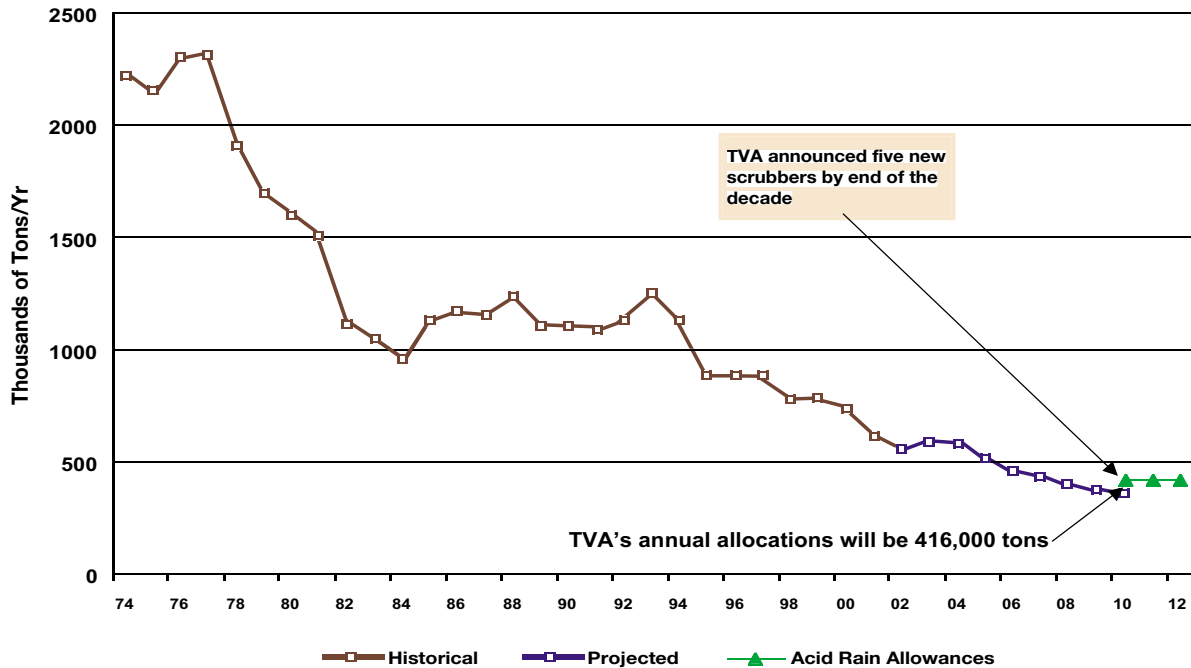


Figure 3
TVA Emissions of SO₂



TVA's Financial Challenge

TVA must continue the progress it has made in recent years in building positive cash flows and reducing the debt burden. At the same time, it must remain competitive and fund the known costs of emission controls.

The mounting costs of TVA's clean air compliance will push TVA into a position where its expenditures are projected to exceed its revenues. As stated earlier, evolving regulations under the Clean Air Act or additional new clean air legislation could drive TVA's costs even higher.

Figure 4 is taken from the January 22 TVPPA Rates and Contracts Committee presentation in Nashville. While these financial projections, based on TVA's business plan from last summer, indicate a reasonably healthy level of average cash flow for TVA over the entire period 2003 – 2015, the projected cash flows are negative in the near-term. For the period 2004 – 2006, TVA anticipates that without a rate increase, total expenditures are projected to exceed revenues by some \$200-300 million annually. For planning purposes we have assumed that future emission control requirements will be similar to those in the President's Clear Skies Initiative. This does not indicate that we believe Clear Skies will become law; but since Clear Skies is one of the least

costly proposals introduced to date, we believe it is imperative that we begin planning for pollution control expenses beyond 2010.

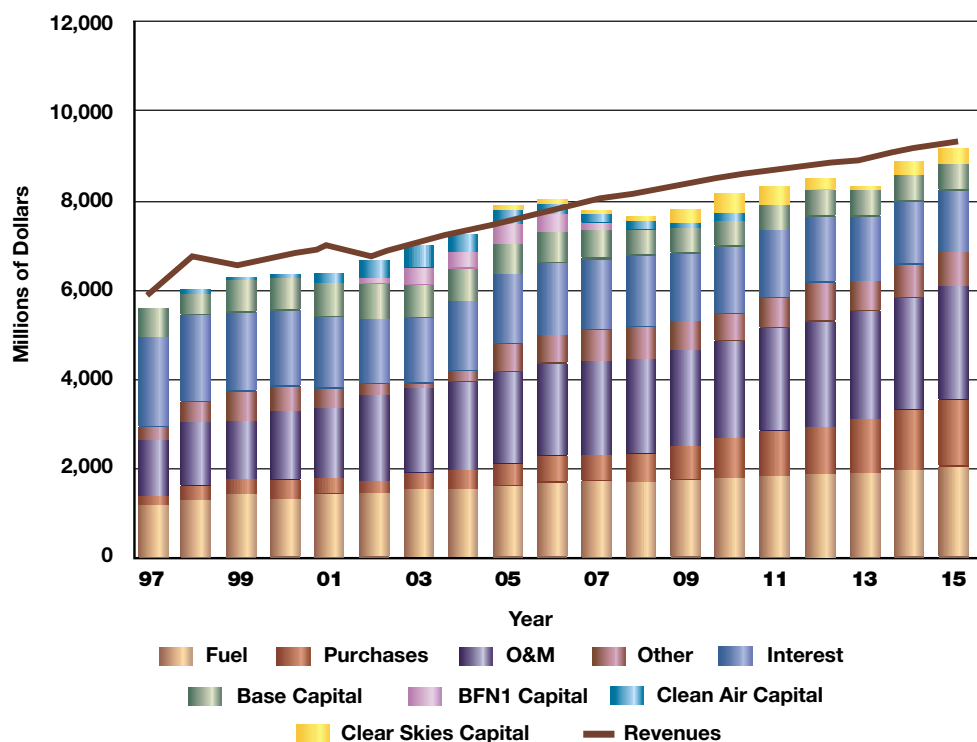
Financial projections beyond even one or two years become increasingly uncertain. In developing long-term performance and spending targets, TVA management sets aggressive "stretch" goals to challenge employees to achieve continuous improvement in business performance. In reality, the level of performance shown in Figure 4 is at the upper end of the range of probable outcomes. Forecasting future revenues introduces more uncertainty as they are affected by factors beyond TVA's control, such as weather and overall economic conditions. A forecasting error of 5 percent can result in underestimating TVA's total revenues or costs by \$350 to \$400 million in one year.

These numbers will continue to be updated and reviewed by TVA management. The financial forecast that will form the basis for developing TVA's final 2004 budget will not be developed until August or September.

Business Environment

Today, TVA faces a more uncertain business outlook than five years ago. At that time, for the most part, we had 10-year power supply contracts. We have only five-year contracts with many distributors today.

Figure 4
Revenues vs. Cash Outflows



We are talking about options for longer-term contracts, which will remove some—but certainly not all—of the business uncertainty.

The uncertainties of future power markets and the regulatory framework increase the risk of recovering the cost of major capital investments. We believe a prudent time frame for recovering the cost of most investments is 10 years or less. The potential rate increase would recover TVA's known clean air investment in about nine years. Consistent with this philosophy, the Browns Ferry Unit 1 investment is projected to pay for itself in about eight years once the unit goes into service in 2007.

Conclusion

The prospect of raising electric rates is not taken lightly by TVA, and this action, if approved by the TVA Board, would be only the second rate increase by TVA in 16 years. The driving force for this potential rate increase is the public mandate for cleaner air—a goal that TVA fully supports but also one that is by and large outside of TVA's control.

TVA remains committed to its strategic objective of meeting customers' needs for affordable, reliable electric power. We thank you for your efforts to work with us over the years and for your shared commitment to public service.

Sincerely,

Mark O. Medford

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